Bahl&Gaynor
Investment Counsel

A letter from

Bahl & Gaynor's Chairman

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2018: A Brief Review

If you moved to a remote island at the beginning of the year and returned to see the market was down single digits at year's end, you might have concluded the intervening twelve months were rather boring.

Quite to the contrary, the S&P 500 reached 60 all-time highs during the year – the third-highest count on record. The yield range of the 10-year Treasury was the narrowest since 1965. The year started with a nearly 6% rise in the S&P 500 for January, only to be followed by a 10% decline in the first ten days of February. The index clawed its way back just over 9% by September. The fourth quarter was characterized by high volatility with multiple days of +500-point swings in the Dow Jones Industrial Average (DJIA). In fact, the Christmas holiday week was extraordinary in its extremes: the worst Christmas Eve showing for the DJIA in its history, the largest single-day gain (1,086 points) for the same index the next trading day and the largest intra-day recovery the day after that.

The market seemed to obsess over the risk of potential economic overheating in the first half of the year. The second half of the year was dominated by a grave concern of a forthcoming recession. A boring year indeed!

Volatility Has Returned

It was only a year ago when some market pundits argued market volatility was a thing of the past. Looking back to the 2010-17 period (see exhibit below), the S&P 500 experienced +/-1-2% daily price changes on 21.6% of trading days, +/-2-3% daily price changes on 4.6% of trading days and >3% daily price changes on only 1.2% of trading days.

Daily S&P 500 Price Action Observation *(Number of Trading Days: 2010-2017)*

Year	+/-1-2% Daily Price Change	+/-2-3% Daily Price Change	>3% Daily Price Change
2017	8	0	0
2016	48	9	1
2015	72	10	3
2014	38	6	0
2013	38	4	0
2012	50	6	0
2011	96	35	12
2010	76	22	8
10-17 Avg	21.6%	4.6%	1.2%

Source: Factset, 2018.

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Volatility Has Returned *Continued*

The 5-year period of 2013 through 2017 in the table witnessed **only 33 trading days** when the market moved 2% or more in a day. This year (2018) has ended the relative calm of the last few years with significant reversion to more normal levels of daily price volatility.

Volatility patterns are linked to investor uncertainty and fear. Sustained periods of market volatility generally coincide with economic recessions. The Great Depression, the energy/political crisis of 1973-74, the crash of 1987, the Gulf War, the bursting of the tech bubble in 2000-02 and the Great Financial Crisis in 2008-09 all exhibited such sustained periods of volatility. The 1930s were especially volatile with +/-1% daily price moves in over half of the trading days during that decade. Since 2000, the market has experienced two 50% or greater declines – from 2000-02 (tech bubble bursting) and 2008-09 (Great Financial Crisis). In the years accompanying the tech bubble bursting, +/-1% daily price moves represented approximately 45% of trading days. Similarly, in the years accompanying the Global Financial Crisis, +/-1% daily price moves occurred during 50% of trading days.

Uncertainty assuredly increased as 2018 progressed. Trade issues, change in control of the House, the special counsel investigation into the 2016 presidential election among other issues seemed to dominate media outlets. These issues are likely transitory in nature. The more significant determinant of future volatility levels relates to the US economy's proximity to the next recession. So far, there is little evidence to suggest a recession is imminent. Unemployment is low, consumer sentiment remains strong and business spending surveys are at the upper end of their historic ranges. The only recessionary indicators flashing yellow are credit dynamics (more on this in the next section) and the flattening yield curve. This cautionary yield curve indicator could be mitigated if the Fed signals fewer rate increases in 2019 as it appears to be doing relative to guidance given just a few months ago.

Putting 2018 into context with market history going back to 1928, this year actually reflects an average year in terms of daily price action (see below):

S&P 500 Comparative Daily Price Action
(2018 vs. 1928-2018 Minimum, Maximum and Average)

	+/-1-2% Daily Price Move	+/-2-3% Daily Price Move	>3% Daily Price Move
2018	44	14	6
1928-2018 Average	60	17	7
Maximum	181 (in 1932)	132 (in 1932)	94 (in 1932)
Minimum	3 (in 1964)	0 (11 observed years)	0 (34 observed years)

Source: Factset, 2018.

The large point swings of major market indices in late November and early December are certainly attention-grabbing events, but they only amount to approximately 3% price moves based on current index levels. Again, going back to 1928, the top 20 daily price moves of the S&P 500 were closer to +/-10% (illustrated on page 4) – severe by today's standards.

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Financial Planning Update:

The Value of Talking to Adult Children About Your Finances

Have you had the conversation with your children about your finances and financial plan? Talking about your financial plan is key to making your goals a reality. Some families are reluctant to have this conversation because they believe it will promote a sense of entitlement among their children or otherwise jeopardize the implementation of their plan.

Below are some tips to help start this important conversation with your family.

STOP AVOIDING AND START THE DISCUSSION

Don't wait for the discussion to become an absolute need before you have this conversation with your family. It is important to talk about your wishes before you are unable to make you own decisions. Without preparation, you leave your family to make important financial and health decisions without your input. Having a proper plan in place that you have conveyed to your family can save time and money.

EASE INTO THE SUBJECT

You do not have to convey your wishes to your family in one conversation. This topic should be covered in a series of discussions. This will allow you and your family to get more comfortable with having this conversation. Once you have conveyed your wishes, you should have periodic family meetings to review your plan.

GET DOCUMENTS IN ORDER

To prepare for these discussions, gather all your important documents to share with your children. These include investment account statements, bank statements, insurance policies, estate planning documents, an inventory of liabilities, and professional advisor contact information. Providing your family with this information will guide them should anything happen to you. Keep this information in a file (hard copy or electronic) that your family can access in a timely manner.

EXPLAIN YOUR DECISIONS

Explaining your decisions to your family can prevent any confusion about your plan in the future. It is important for your family to know why you chose your executor, trustee, power of attorney, etc. Explain to them your asset distribution plans and why you have decided to distribute assets in the particular way outlined. It may be beneficial to your heirs if you explain these decisions in narrative form. This is a good time to answer any questions your family has regarding your financial plan.

INCLUDE YOUR WEALTH ADVISOR

Introduce your family to your wealth advisor. Your wealth advisor can help you initiate an effective family conversation regarding your financial plan and answer any questions that your family has as well. Finally, establishing a relationship between your family and your advisor will help them work together on your plan if something would happen to you.

If you have not had this conversation with your family, it is never too late to start. Ease into this conversation with your family and it will create a more open dialogue. If you would like Bahl & Gaynor to schedule a family meeting to discuss your financial plan or have questions regarding discussing your finances with your family, please contact your Bahl & Gaynor portfolio manager.

Volatility Has Returned *Continued*

S&P 500 Largest 20 One-day Gains & Losses *(1928-2018)*			
Largest One-day Gains		Largest One-day Losses	
3/15/1933	16.61%	10/19/1987	-20.47%
10/30/1929	12.53%	10/28/1929	-12.94%
10/6/1931	12.36%	10/29/1929	-10.16%
9/5/1939	11.86%	11/6/1929	-9.92%
9/21/1932	11.81%	9/3/1946	-9.91%
10/13/2008	11.58%	10/18/1937	-9.12%
10/28/2008	10.79%	10/5/1931	-9.07%
6/22/1931	10.51%	10/15/2008	-9.03%
4/20/1933	9.52%	12/1/2008	-8.93%
8/8/1932	9.26%	7/20/1933	-8.88%
10/21/1987	9.10%	9/29/2008	-8.81%
11/14/1929	8.95%	7/21/1933	-8.70%
6/19/1933	8.87%	10/10/1932	-8.55%
8/3/1932	8.86%	10/26/1987	-8.28%
7/24/1933	8.81%	10/5/1932	-8.20%
10/8/1931	8.59%	8/12/1932	-8.02%
12/18/1931	8.29%	7/26/1934	-7.83%
2/11/1932	8.27%	6/16/1930	-7.64%
5/1/1933	7.66%	10/9/2008	-7.62%
6/10/1932	7.66%	5/14/1940	-7.47%
Average	**10.09**	**Average**	**-9.48%**

Source: Factset, 2018.

Although recently higher volatility levels can be distressing, it is not unreasonable to argue higher levels of volatility versus the past few years may be the new normal. Substantial Federal Reserve accommodation provided through both low policy rates and quantitative easing supported widespread asset appreciation and a consequent dampening of price volatility. Logically, a withdrawal of such accommodations could precipitate more volatility, or at least more volatility relative to an era of unprecedented market intervention. The prospective reality of more volatile capital markets reinforces the value of a focus on quality. Moreover, the presence of higher volatility levels could dictate a greater percentage of equity total return will be derived from the contribution of dividends rather than capital appreciation.

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Corporate Debt Revisited

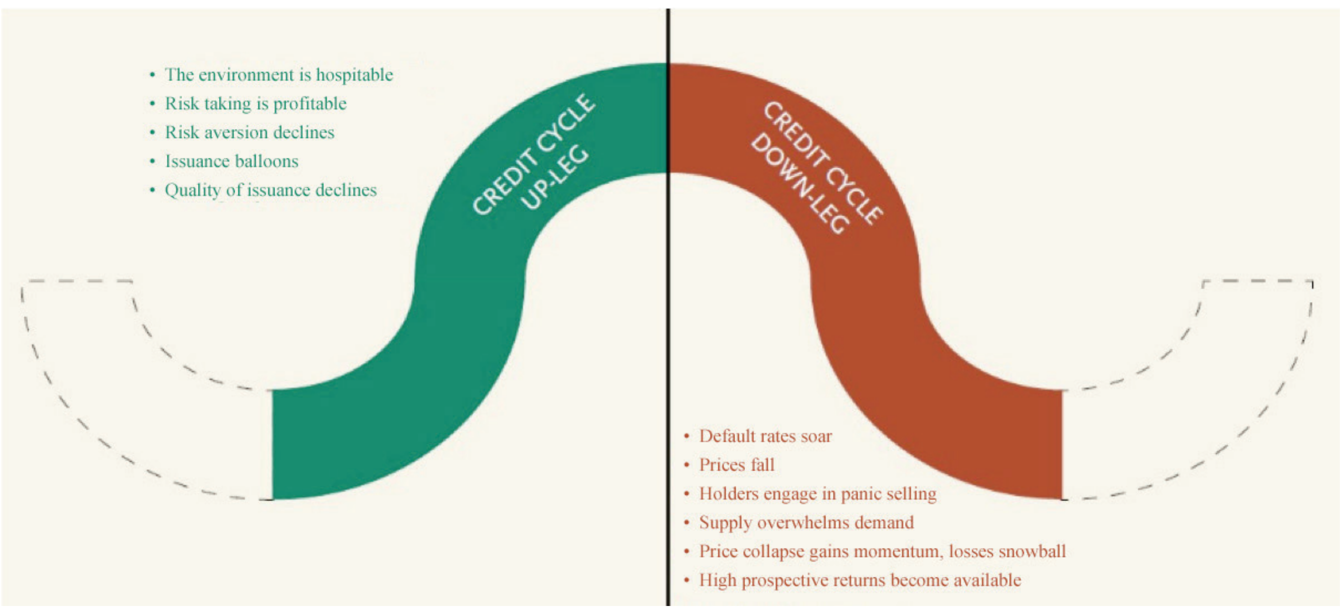
Earlier in this note, we referenced two recessionary indicators we believe are flashing yellow: corporate credit dynamics and a flattening yield curve. We believe it is important to dedicate the rest of this letter to a discussion of leverage, in this case, corporate credit dynamics.

Bahl & Gaynor's investment philosophy has always centered upon owning high-quality, dividend-growth equities for long periods of time. This philosophy has not changed since the founding of our firm. What has always changed is the investment environment around us. Sometimes the environment favors our strategy and sometimes it does not. Like many things in our daily lives, the investment environment is cyclical, and the dynamics of debt or leverage are no exception.

Before we discuss the cyclicality of debt, let us first briefly review debt from a definitional standpoint. Debt is simply future consumption pulled forward to today – and it must be repaid to avoid perilous consequences. Debt can be good so long as the proceeds from issuing it are used wisely. But like most good things, debt can become onerous when too much of it is employed or the proceeds from it are invested poorly, or both! An overly indebted person, corporation or government can be faced with difficult decisions to improve their situation. Setting aside options like outright default (the most serious alternative in managing excessive debt), deleveraging must come from sources like lower consumption and investment. Unfortunately, the deleveraging process can be quite painful as it tends to promote a deflationary feedback loop on a macroeconomic level. Deleveraging reduces consumption and investment, which reduces economic activity, which further reduces the ability to repay debt, requiring even greater cuts to consumption and investment – and so forth.

We mentioned before that debt is cyclical – this concept is often referred to as the credit cycle (illustrated below). Credit cycles tend to be long and gradual. At the beginning of the cycle, debt levels are low and the positive feedback loop of debt-financed purchases results in risk-taking behavior being rewarded. During this opening phase of the cycle, headlines of debt-funded acquisitions and material share repurchases are ubiquitous and usually rewarded with higher stock prices. Skepticism is low, and greed rules the day. It is important to note that the vulnerabilities of excessive debt are ignored during this boom phase because there is always a market participant willing to roll over maturing debt or finance management empire building.

The Credit Cycle



Source: Howard Marks, 2018.

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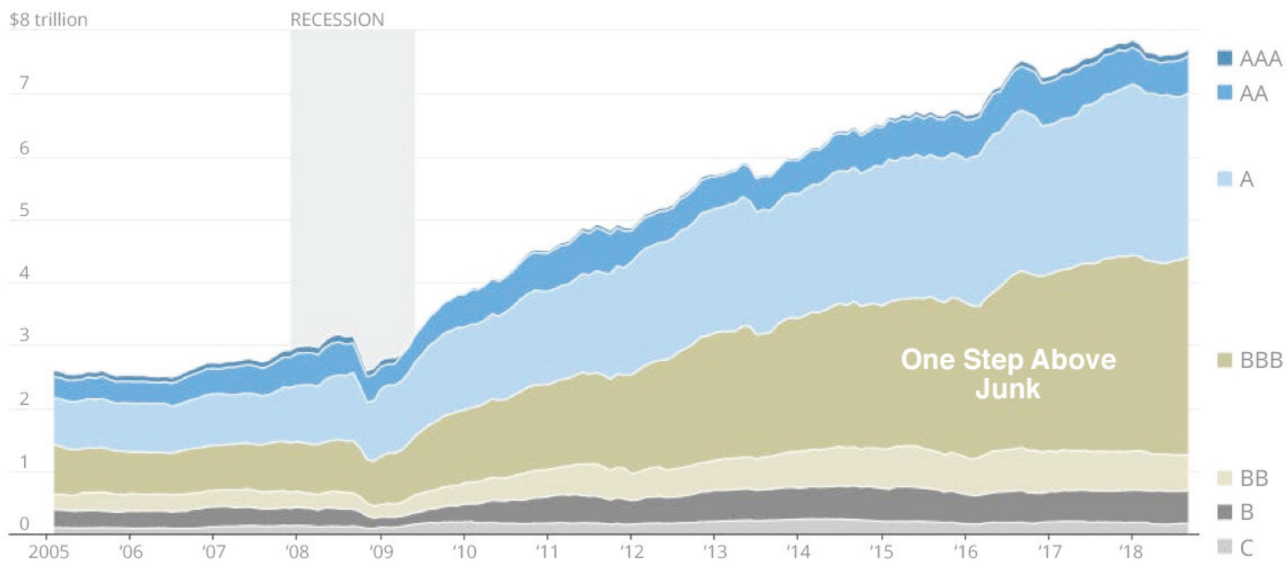
Corporate Debt Revisited *Continued*

At a certain point in the cycle, the marginal benefit of incremental debt diminishes. The cycle peaks and cracks begin to emerge in more levered and cyclical companies. The bill for the boom begins to come due. Credit spreads begin to widen, and we see more selective access to credit granted by credit markets. **Bahl & Gaynor believes we are at or near this point in the credit cycle today.** The aforementioned vulnerabilities of excessive debt that were ignored on the way up come into intense focus after the peak of the cycle. These excesses are revealed as incredibly foolish in hindsight and lead to higher financing costs for less creditworthy borrowers. Higher financing costs come in two forms: higher nominal debt coupons and more restrictive covenants. Both are headwinds to future growth and incentivize debt repayment versus investing for growth in terms of capital allocation priorities – this process is known as deleveraging.

As the cycle turns to deleveraging, the reaction is often violent and only the highest-quality companies are afforded access to capital. Highly-levered, low-quality companies are forced to cut dividends, sell foundational assets at fire-sale prices and/or raise equity to maintain corporate viability. The ultimate result for equity investors who enjoyed the ride on the way up or tried to catch a falling knife amid the reckoning is a permanent loss of principal.

Turning to the present credit cycle, and in contrast to prior cycles, the substantial increase in corporate debt has come at the investment-grade level, specifically BBB credits as indicated in the graph below. Much recent M&A activity has taken the leverage of acquiring companies to levels that imperil continued investment-grade ratings for these issuers. Maintaining an investment-grade rating is often a priority for issuers because financing costs are usually lower and the market for investment-grade issues is larger than that of "junk" or high-yield securities. In order to avoid credit rating downgrades into high-yield territory, these companies must promise to reduce debt quickly to appease rating agencies. Successfully delivering on these promises requires a benign economic environment and flawless execution of merger plans as outlined. Economic disruption or hiccups in merger integration proceedings risks leaving highly indebted companies at the mercy of capital markets – a precarious position in a time of market stress.

Value of US Corporate Bonds by Credit Rating



Source: ICE Data Services, 2018.

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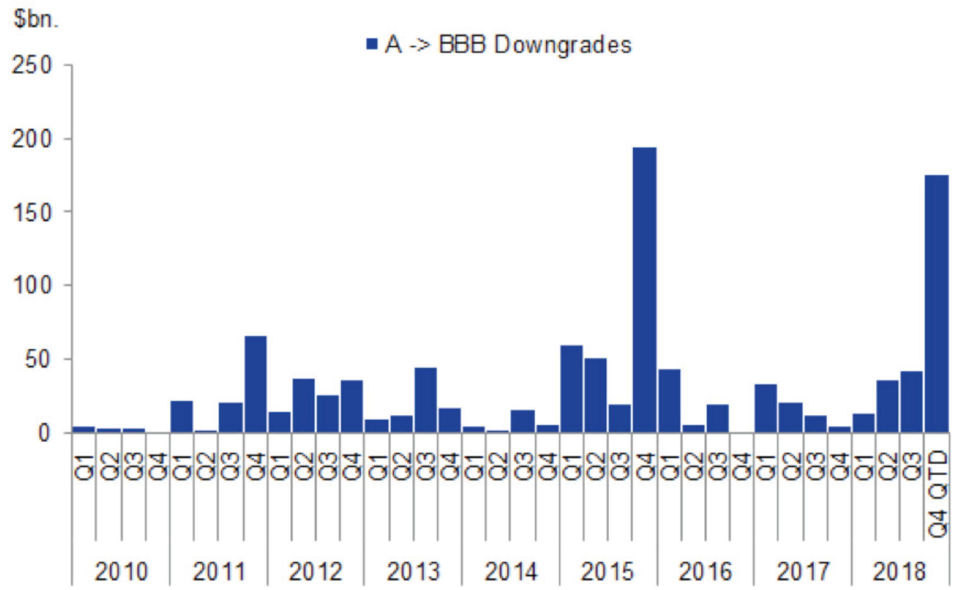
Corporate Debt Revisited *Continued*

Bahl & Gaynor's Investment Committee is witnessing a concerning amount of the aforementioned activity. We believe the number of "fallen angels" (formerly investment-grade issuers downgraded into high-yield territory) will increase materially in coming years. To this point, the chart below illustrates a near-record migration of formerly highly-rated issues to barely investment-grade status. This is during a period of heightened but not recessionary economic stress, implying further damage could be done when the economic cycle eventually moves into contraction.

A to BBB Downgrades by Quarter ($ billions, 2010-2018)



Source: Bloomberg, Goldman Sachs Global Investment Research, 2018.

As Bahl & Gaynor positions client portfolios, we are focused on much more than just credit ratings. Cash flow is also a critically important element of our analysis. We believe significant risk exists with companies that have visible cash flow gaps or shortfalls due to large capital outlays (committed projects, M&A or prior capital allocation decisions). These companies are reliant on external sources of capital (debt or equity) to finance their operations. And as described earlier, in an unfriendly capital market environment, these companies can be held hostage and forced into difficult decisions to conserve and preserve capital. Dividends may become an expendable luxury for many compromised issuers in this kind of environment.

Bahl & Gaynor believes the best "defense" is a sound "offensive" approach, especially at this stage of the credit cycle. Investors can enjoy success through an economic cycle by owning companies that are able to operate (and deliver dividend growth) even in the absence of economic prosperity. It is our belief that continuing attentiveness and selectivity through our bottom-up, high-quality approach will yield benefit to clients through a full market cycle.

We thank you for the opportunity to serve your investment needs and we wish everyone happy and prosperous new year.

Sincerely,

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Disclosure: